

DEVELOPING A CASH FLOW PROJECTION FOR BUSINESS START-UP AND EXPANSION

BACKGROUND

Developing accurate projections, especially the sales forecast, is probably the most difficult part of building financials for your business plan. Unfortunately many people don't spend enough time and effort on this part of their plan and end up living with the consequences after their project is funded.

The numbers used for your forecasts are derived from numerous sources. However, the foundation of forecast starts with a competitive analysis of your market.

THE MARKET

As you do your research, focus especially on the following questions:

- 1) What is your overall market size?
- 2) What is the growth potential?
- 3) How is the market segmented?
- 4) What is your target market strategy and have you clearly identified your product or product line?
- 5) Is my business idea good for this place, this time, and my resources?
- 6) Who are your competitors and what products and services are they providing?
- 7) Is your business impacted by national/world markets and economic conditions across the U.S. and abroad? If so, in what way?

RESEARCH IS EVERYTHING

You need to satisfy bankers and yourself that your plan and projections are viable. The best way to do this is to investigate every reasonable source of information that will help frame the market potential for your business. Plan on spending weeks, if not months, to do this. You should be able to go start your business knowing or at least reasonably assured that there is a piece of the market pie for you to put on your plate. The surest way to lose your business is to use anecdotal, inaccurate, or incomplete information.

After you have gathered all of the possible pertinent information, sift through it and use the best parts for your plan and projections. There is still risk of failure but you will have improved your chances dramatically and increased your knowledge base significantly.

If you are still not confident about proceeding, then change or even consider dropping your plan. **Things will not get better by going into business.**

WHERE IS THE INFORMATION?

There are two sources of information - primary and secondary. Primary sources are usually not available in written form. Primary sources are typically interviews, questionnaires, surveys, focus groups, or first-hand observation. Most of this is too expensive and time-consuming for potential small businesses and sometimes difficult to interpret, while secondary sources are generally more reliable and easier to find and use. Secondary sources already exist primarily in written form.

Make sure the information you gather is current and correct. This research is to help you survive. You should not be spending your time creating a pretty document.

DEVELOPING A CASH FLOW PROJECTION FOR BUSINESS START-UP AND EXPANSION

BUILDING YOUR FIRST YEAR CASH FLOW PROJECTION

#1 – PRE-START-UP POSITION

The pre-start-up section of your cash flow projection is useful to start-ups and expanding businesses because it helps to define and confirm the exact amount of debt and equity financing you will need and what type of financing will be needed: Term debt, revolving credit line, seasonal line, short-term, long-term, etc. It also clearly defines where the initial infusion will be spent and how much will be left over as cash on hand to start or expand your business. (It should also correlate exactly with your “sources and uses of funding” contained elsewhere in your business plan.)

Total business start-up cost – Add up the total cost of equipment, inventory, land, buildings, loan payoffs, and one-time pre-start-up expenses such as pre-paid rent, pre-paid insurance, and any other cash layouts you need to start or expand your business. This figure will be deducted from your available equity and loan start-up funds. When finished, the excess ending cash will roll to the top of your sheet as starting cash. Your ending cash must always be positive, otherwise you are out of money, which won’t work.

#2 – THE SALES FORECAST

Now you are ready to actually see if your cash flow will support your business. (*Note: All figures used in your cash flow forecast should be rounded to the nearest dollar.*)

A. Some background factors – You have determined that your first year annual sales will be \$_____. This was based on:

- a favorable national industry outlook
- a favorable economy
- association information
- favorable competition in your area
- a proposed superior or unique level/type of service
- threshold studies from a neighboring state indicating a market potential
- product differentiation and availability not offered by others
- demographics for your area indicating a large potential customer base cross-referenced by buyer profiles obtained
- in-depth conversations with a friend successfully operating a similar business in a similar market outside of your area
- the retirement of a large competitor
- a national supplier stating that he supplies 3 times your proposed level of sales to a business in a town similar to yours
- a local economic development study that highlights community needs including your products
- large out-of-state demand for your type of product if you have mail-order capabilities
- you have obtained an exclusive dealership in your area for an exciting and in-demand product
- a general increase in manufacturing or large basic industry operation moving to your area
- the availability of an excellent business location at a very reasonable price
- availability of superior merchandise at an extremely low price not known or unavailable to your potential competitors
- cross-checked your sales estimate with industry-average sales per square foot (Business and Industry Financial Ratios information indicating average sales for your type of business are about \$_____.)

A preponderance of positive factors is a good indicator for your business potential. These are just a few examples of positive factors and methodologies to determine what your initial forecasted sales level could be. Any of this relevant evidence should be used as an exhibit in the appendix section of your business plan. You can refer back to these exhibits to strengthen various parts of your narrative and financials.

B. A micro look – Now look at your sales forecast on a micro level. How many people on average need to walk into your store every day and purchase X amount of merchandise each to reach your forecast?

DEVELOPING A CASH FLOW PROJECTION FOR BUSINESS START-UP AND EXPANSION

Is this realistic, based on average purchase amount for these types of products? Based on area demographics cross-indexed with customer profiles? Based on your store hours? Is your product really needed or can people buy the same thing at Wal-Mart for 80 percent of your price? You need to ask these types of questions prior to pulling the trigger.

C. Seasonality of the forecast – Many businesses sell their products or services at different levels for different times of the year. You need to get a handle on this. If you don't, you will find yourself very short of cash on any given month. The Bureau of the Census Economic Census data will provide seasonal indices for a given industry sector. This information is available online at <http://ceic.commerce.state.mt.us/>. Trade associations, suppliers, consultants, business acquaintances, and others can also assist with determining the seasonality of your business. For example, 35% of your business may occur in December, 5% in January, February, and March, 7% in April and May, 10% in June and July, 3% in August, September, and October, and 7% in November. This will also affect your product purchasing cycle and your inventory needs. **Don't divide your annual sales by 12.**

D. More than one product or service – If you have more than one product or service you should initially break them out separately on some type of matrix and project them separately. They probably have different costs of good sold (COGS) percentages and you need to illustrate this. Each category is likely to have separate seasonality profiles also. The SBA cash flow form #1100 can be modified to reflect this as well as any computer spreadsheet you are using. You can later combine them for your total annual income forecast.

E. Sales build-up – You are not going to come out of your blocks at full speed in regard to sales. Estimate a reasonable build-up. For example your first 3 months of sales might be \$6000 per month, then 2 months of \$8,000, then \$10,000 in month 6. You might be able to confirm this build-up via association data, a similar business in a nearby state that recently opened, supplier advice, or some other source. Don't rule out common sense.

F. Cash sales versus credit sales – If you are selling some or your entire product on credit you will need to account for this on your cash flow forecast. If you are using a computer you can build a "booked" sales line that represents your total cash and credit sales, then apply percentage estimates of cash sales and credit sales against your total sales to determine the estimated dollar amounts. Let's say that 50 percent of your sales are cash and 50 percent are credit, with an average collection of 60 days, (2 months). On \$6,000 total sales for your first month you show \$3,000 in available cash sales. The other "unavailable" \$3,000 will be shown on your credit collections line 60 days or 2 months later. Be conservative when estimating the availability of receivables. These "receivables" are a big issue, especially with start-ups and growing businesses, because you have spent money to acquire your products or services but won't receive cash to run your business until later. You will need to finance the forecasted receivable deficit up front to cover your cash needs.

#3 – COST OF GOODS SOLD

A. (COGS) – (sometimes shown as purchases or merchandise cost). These figures represent the price that you pay for your merchandise to be resold. **You need to know the dollar value and the percentage of sales that this cost represents.** For example, if you sell something for \$100 and you paid \$50 for it then your cost of goods sold percentage is 50%, (50 divided by 100). How is this percentage determined? You need to contact your suppliers and find out what you will pay for a given product and what the suggested retail price or market-justified price will be. Divide your cost by your selling price and you have your percentage. Obviously for services, cost of goods sold does not apply. You should also consider competitor pricing for comparable products.

You now need to consult Risk Management Associates (RMA) or Dun & Bradstreet (D&B) Annual Statement Studies and compare industry averages by percentage with what you are forecasting. Your projections need to fall in their range for a couple of reasons. RMA and D&B data is fairly reliable and used by bankers and others. If you fall below normal ranges then you are better than everyone else in the U.S. This is unlikely, since you are just starting up and your local banker knows you are not going to do better than industry averages, especially being the new person on the block. If you can unequivocally back

DEVELOPING A CASH FLOW PROJECTION FOR BUSINESS START-UP AND EXPANSION

this up then go for it but be prepared to logically prove it; otherwise go back to the drawing board. If you are above the average cost of goods percentage you also have a problem because you won't be competitive and will likely go out of business because you won't be able to cover your other costs. Again - back to the drawing board.

B. Start-up inventory – One critical figure that needs to be determined early on is your start-up inventory level. **Once determined, this figure needs to be plugged in as an additional start-up cost in the pre-start-up position on your forecast.** Initially you will need to determine if your industry has any special purchasing season or if you need to purchase your entire inventory at the beginning of the year. Assuming you are planning on replacing inventory as it is sold, you will first need to determine the total amount of inventory needed based on your forecasted sales. **Multiply your COGS percentage by your total forecasted sales, which will yield your total annual inventory needed. Divide this total inventory by RMA, industry average, or D&B average inventory turns per year and this will give your needed inventory at start-up.**

Example: Forecasted sales = \$100,000

COGS percentage = 50%

Total Annual Inventory = \$100,000 x 0.50 = \$50,000

Average Industry Inventory Turns = 9 turns per year

Therefore: Start-up Inventory needed = \$50,000 divided by 9 turns = \$5,555

#4 – EXPENSES

Every figure used here should represent a phone call, a letter, an informed estimate, a conversation, a quote, updated records, association estimates, “cost of doing business surveys”, utility records, schedule C tax records, or any reliable source of information. In other words, don't just pull numbers out of the air.

#5 – LOAN INTEREST AND PRINCIPAL

Calculate your monthly payments on any loan(s) and break them out by interest and principal. If you have more than one loan or credit card then break them out separately by interest and principal. Interest is tax deductible and principal is not. This breakout is useful later for completing income statements and calculating various ratios.

#6 – CAPITAL PURCHASES AND OTHER START-UP COSTS

Enter any capital purchases such as equipment, furniture, fixtures, or any major purchases that require cash outlays. Other start-up costs could include your initial starting inventory and any other miscellaneous large start-up costs. Keep in mind that these items can occur at any time of the year and will affect your cash flow.

#7 – OWNER'S DRAW

If you are a sole proprietorship or partnership then enter your personal cash withdrawals here. If you are incorporated, then enter your salary in the gross wages line. You need to at least cover your personal expenses. An exception is income from an outside source for your personal needs that may allow you to forego withdrawals from your business.

One way to determine an acceptable income is to find the RMA average % owner compensation for your type of business and multiply by your projected sales. Then see how it affects your cash flow.

#8 – INCOME TAXES: FEDERAL AND STATE

One area that will definitely impact your cash flow is taxes. Calculating tax from a cash flow statement is quite a paradox. You will need to calculate your tax based on your net income after depreciation. Since depreciation is a **non-cash** income statement and balance sheet item, you will need to calculate your tax liability from an income statement forecast. You will need to apply 30% – 40% (avg. 15% Fed., 10% State, 7 % S.E.) to your **net income after depreciation**. This may vary according to your

DEVELOPING A CASH FLOW PROJECTION FOR BUSINESS START-UP AND EXPANSION

personal situation and your company's legal business structure (proprietor, LLC, C or S corporation, etc.). Apply this amount **usually in quarterly amounts or when you expect the payments to actually fall due**. The amounts are placed in your cash flow forecast in the bottom section of your cash flow statement (i.e., in the capital purchases, owner withdrawals area).

#9 – CASH POSITION (Ending Cash)

This figure needs to be positive for each month. If you end up negative here you will need to make adjustments. You have several remedies:

- 1) Increase your loan or equity infusion
- 2) Increase your projected sales
- 3) Speed up collections on your receivables
- 4) Reduce expenses
- 5) Delay expenses or purchases to a more favorable time
- 6) Reduce owner withdrawals
- 7) Sell an asset for cash (you can enter this on the *equity infusion* line at the top and explain it in your notes.)

It is also important to have a cash cushion at the end of each month. For most small businesses this should be at least a few thousand dollars. In some cases this could be as high as three months expenses. The ending cash figure rolls up to the top of the sheet and becomes the starting cash for the following month.

FINAL NOTES

- 1) Check and double-check your figures! The quickest way to have your business plan turned down is to have incorrect numbers. Your cash flow figures need to cross-index with all other figures in your business plan. **These figures need to be linked to the business plan text!**
- 2) Use of any loan proceeds and equity injections must be clearly shown in your proforma cash flow, usually in the pre-start-up position. Periodic injections must also be clearly shown in regard to timing and amount. This should also correlate with your sources and uses statement contained in your business plan.
- 3) As you develop your figures, have a sheet of paper handy to write down your assumptions as you go for each category. Line by line assumptions (sometimes called “notes” or “explanations”) are normally required as part of a business plan and will be on separate sheets following your figures. Bankers and other interested parties want to follow your logic and see that you were diligent in researching your projections. It will also be much easier than trying to remember later.
- 4) This is a classic application of computer spreadsheeting. Computerizing cash flow allows you to easily calculate “what if” scenarios and will save you loads of time.
- 5) **PLEASE develop a group of advisors; legal, accounting, financial, SBDC, SCORE, and area business people you can TALK TO PRIOR to any financing for a business start-up, expansion or business purchase!**
- 6) You need to understand all of the figures in your business plan and **be able to explain them clearly** in regards to how they were derived and calculated.
- 7) If you are basing some of your projections on historical performance of your company or a company being acquired then you also need to justify these historical figures.
- 8) You will be filling out a personal financial statement if you are seeking a loan for your business. Make sure that the owner withdrawals on your cash flow projection exceed the personal needs stated in the personal financial statement you submit.